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C O N F I D E N T I A L SECTION 01 OF 04 TEGUCIGALPA 000772

SIPDIS

STATE FOR WHA AND EEB
TREASURY FOR SARA SENICH AND WILLIAM FOSTER
STATE PASS TO USAID/LAC

E.O. 12958: DECL: 08/21/2018
TAGS: EFIN EAID ENRG EPET PGOV PREL IMF VE HO
SUBJECT: FAINT HOPE FOR IMF STANDBY AGREEMENT IN HONDURAS

REF: TEGUCIGALPA 518 AND REFTELS

Classified By: Charge D'Affairs Simon Henshaw for reasons 1.4 (b) and (d)

¶1. (C) Summary. After a reluctant IMF assessment visit August 12-15, the IMF officially concluded that fiscal policies are broadly on track, while advising the GOH to strengthen its monetary and exchange rate policies. Underlying the terse public statement was a private consensus among IMF officials that the Precautionary Standby Agreement is all but dead, with only faint hope it can be revived. According to IMF ResRep Mario Garza, abysmal monetary policies are the real problem, not ballooning public sector wages as claimed by the press. Compounding the frustration of IMF officials is a complete lack of urgency on the part of the GOH economic team to draft practical fixes to problematic policies, and Garza does not expect any serious attempt to get the program back on track. End Summary.

Monetary Policy Had a Stronger Effect Than External Shocks

¶2. (C) An International Monetary Fund (IMF) assessment mission reluctantly visited Honduras for the first official review of April's Precautionary Standby Agreement August 12-15. The mission's reluctance was based on a well-founded belief that Honduras was unlikely to complete its review at this time, which was proven right. A terse August 18 press release commending fiscal policies as broadly on track, while advising the GOH to strengthen its monetary and exchange rate policies was a face saving measure, according to IMF ResRep Mario Garza. He said there was a surprising amount of distance between IMF and GOH officials. IMF officials articulated that poor monetary and exchange rate policies are the primary reason Honduras is not completing its agreement. By contrast, Central Bank (BCH) President Edwin Araque flatly stuck to his position that deviations in the program resulted solely from external shocks, namely domestic demand pressure, and it was therefore unwise to "overreact." IMF officials reminded Araque that they had advised Honduras in May to consider the shock permanent (reftel), therefore eliminating international reserves as a possible temporary fix. They also acknowledged the unexpectedly strong effect of external shocks - about four percent of GDP - but also pointed out that simultaneous positive shocks such as remittances and the attractive price of exports resulted in a net negative effect on the terms of trade of only about two percent. Araque could only respond that President Zelaya will not allow him to react on monetary and exchange rate policy.

¶3. (C) The IMF mission was careful not to tell the GOH outright that its monetary policy is expansionary, instead suggesting the GOH is creating a "strong impulse" to inflation by allowing the external current account deficit to grow rapidly. While the program originally envisioned this deficit at nine percent of GDP, IMF expects it will reach 15 percent by the end of the year if not addressed. Araque simply repeated his claim that external shocks were squarely to blame. Garza lamented that while the IMF had focused on finding out what the GOH intended to do to get back on track, GOH officials were more focused on potential press reaction. In the end, the economic cabinet agreed to review the aide memoire and discuss options with the President, only half-heartedly committing to discuss its ideas in Washington in September. Garza noted a complete lack of urgency among GOH officials to develop revised monetary policies and he expects neither a constructive nor timely response.

¶4. (C) The mission also pointed to the huge deviation in international reserves from the original targets. The Agreement called for an increase in reserves from USD 2.473 billion to USD 2.726 billion by the end of 2008. Reserves have instead fallen to USD 2.3 billion, USD 100 million of which was lost in the last three weeks. This represents a deviation of USD 230 million from original targets, and it could reach USD 400 million by the end of the year without appropriate action. Despite the precipitous decline in reserves, the GOH was not prepared to discuss policy responses. Araque dismissed the acceleration in losses as seasonal, claiming that the seasonality will become favorable

in the fourth quarter.

¶5. (C) Garza believes the monetary side of the program is off track for a combination of reasons that boil down to lack of political will:

- President Zelaya was not committed to the program from the beginning.
- The GOH economic team, comprised of BCH President Araque and Finance Minister Rebeca Santos, is weak and is not informing Zelaya that the program is off track, or of the implications.
- Though a capable technician, Araque is first and foremost a Zelaya political loyalist who, like all of Zelaya's cabinet, finds it difficult to advise the President, especially when the advice means changing the current course. He is constantly in "response" mode and lacks strategic vision of where to take the program. This, combined with his tendency to see everything as political, makes it very hard for Araque to counter Zelaya's wild ideas with practical suggestions.
- Zelaya does not see the IMF program as congruent with his increasingly close relationship with Venezuela. Ministers seem to be buying into this trend as well - Finance Minister Santos, who often appears willing but politically unable to pursue rational policies, asked the IMF mission to justify why it is in Honduras' interest to save the program.
- Division within the economic cabinet prevents a practical approach. Previously, various Ministers of the Presidency have been key participants in IMF discussions. The present minister, Enrique Flores Lanza, is completely disengaged. Santos has openly stated to IMF officials she does not like Araque.

IMF says Fiscal Policy Not as Dire as Press Reported

¶6. (C) In spite of failing monetary policy, the fiscal side is broadly on track. As it told the GOH in May (see reftel), the mission is willing to accommodate some deviations in current spending because the oil price shock was much bigger than expected. Additionally, fuel subsidies have been virtually eliminated and electricity subsidies are now

targeted. Garza said the IMF feels the current electricity tariffs are almost consistent with cost recovery and IMF and World Bank energy experts have agreed to meet in Washington to discuss another possible tariff increase of about ten percent. Despite rampant press reports that the IMF is singularly focused on ballooning public wage spending, Garza denied having made statements to the press to that effect, and he suspects Araque is placing the stories in order to divert attention from
monetary policy. On the other hand, Garza thought the misreporting could provide enough steam for Rebeca Santos to get the wage bill she wants, which could help address serious overruns in hiring, especially for teachers, which could account for losses of 0.3 percent of GDP for the year (about USD 60 million).

Bank Supervision Needed

¶7. (C) Garza commented that bank supervision is a weak point of the IMF program, and that banks seem to be operating with increasing freedom in Honduras, signaled by the credit boom over the last year. He sees anecdotal indications that that lenders are finding it increasingly difficult to collect on their loans. The IMF suggested to Banking and Insurance Commission (CNBS) head Gustavo Alfaro that the CNBS should be taking a closer look at individual banks. Garza explained to econoff that the current practice is for most public sector entities to deposit revenues in private local banks, rather than the Central Bank. Because the BCH does not offer market rates and because BCH does not have control over its monetary policy, public sector enterprises have incentive to put this liquidity into private banks, which offer higher rates. In turn, those banks can (exponentially) expand credit portfolios. For example, deposits from state-run telecom company Hondutel were recently shifted from Citibank to Banco Continental, a bank owned by media-magnate Jaime Rosenthal, who is in turn using the funds to expand credit "like crazy." Garza said under Araque, the GOH has intensified the existing

practice of letting public sector institutions deposit revenues in private banks. Though
shifting public sector deposits to the BCH would be relatively simple, and could solve the international reserve deviation, Araque complains it would be too hard to enforce. In fact, Garza suspects Araque knows that taking these deposits away from some banks that could cause a hard landing if the credit situation worsens in Honduras.

What Should Be Done?

¶8. (C) Garza acknowledged that it would not be easy to get the Precautionary Standby Agreement back on track, but said it is theoretically possible by year's end. With concrete action and political will in the short term, IMF is willing to give the GOH some breathing room by pushing back the deadline to March or even June of 2009. He said the mission was careful to leave the solution to the GOH, offering tools such as the monetary policy rate (TPM) and reserve requirements. Garza did, however, present his personal ideas to econoff, which were not articulated by the mission to the GOH:

- The policy interest rate, which is currently negative, must increase substantially (note: Garza noted that Araque consistently responded to this suggestion by pointing out the United States currently has a negative interest rate as well. End Note.)
- Increase reserve requirements for private banks by three percent and increase the TPM by 200 basis points. (Note: Since April the GOH has raised the TPM by 125 points, while inflation has gone up from nine percent to 13.8 percent

year-on-year. End Note.)
- The practice of placing public sector deposits in local private banks should stop, in favor of the BCH. If the lempira-denominated deposits were used to purchase dollars, this could eliminate the international reserve level deviation, since public sector deposits currently stand at about USD 230 million, almost exactly the amount of the reserve losses.
- The GOH should gradually devalue the exchange rate.

¶9. (C) On the exchange rate devaluation, Garza was remarkably frank, saying there was a key difference in opinion between his preferred approach and that of his Washington colleagues. Evidently, the IMF team was authorized to suggest an exchange rate devaluation of eight percent, based on its belief that the terms of trade shock had resulted in overvaluing of the currency by eight percent. Garza himself talked the assessment team out of making that politically-charged suggestion more than once, and told econoff there was a higher chance of selling the Hondurans on gradual adjustments. Garza said the commercial banks would support increases in interest rates and reserve requirements. Losing GOH deposits would be another matter. Garza acknowledged the danger of cutting back credit growth too rapidly.

¶10. (C) Garza said the options now are for Honduras to take quick action to get its program on track or move to Article IV consultations that would end the program. Garza said that for all intents and purposes, the IMF feels the program is dead, but chose to say publicly the program review is continuing on the dim possibility that Vice Minister of Finance Hugo Castillo will convince President Zelaya to make practical policy changes. In the mean time, Washington's IMF office is planning to gracefully put distance between itself and the GOH, canceling trips of advisors on various issues. If Article IV consultations prove necessary, the IMF would do them as late as possible, probably in December. This would allow a board review in February 2009, followed by discussions with the Presidential candidates later in the spring. Garza acknowledged that if the GOH asks the IMF for an assessment letter, it will have to say the program is off track.

COMMENT

¶11. (C) The GOH is using the assessment to pat itself on the

back for its economic success. President Zelaya, with Finance Minister Santos and BCH President Araque by his side, interrupted all local and cable airwaves on the night of August 18 to give the people of Honduras an "economic report." The team announced that the IMF assessment had been "extremely positive." They pointed to "solid" economic growth of six percent for the last several years, rising employment and a stable exchange rate. Despite the IMF Press Release, newspapers have also gotten it wrong, focusing instead on burgeoning wage spending. We agree with Garza's suspicion that Araque is purposely trying to shifting the public discussion of the IMF report from the monetary problems to fiscal problems. Because of his past attempts to manipulate the press in his favor and his loyalty to President Zelaya, we believe he may have a longer term goal of setting up the IMF as the scapegoat when unpopular, and inevitable, restrictions are placed on public sector hiring and wages.

¶12. (C) Given President Zelaya's apparent attempt to solidify his friendship with Venezuela at any cost, the odds of a miraculous recovery of the IMF Precautionary Standby Agreement are close to nil. Post was surprised at Garza's candor in the conversation, considering that he was under instruction from Washington not to brief bilateral and

multilateral missions until the August 27 board meeting. His bosses did not want a repeat of the extremely tense recent World Bank food security budget support meeting in Washington, the readout of which Garza said was leaked to the GOH. The probable death of the Agreement until at least the inauguration of a new administration in January 2010 will make it easier for donors, who are increasingly skeptical of the Zelaya administration's willingness to use multi-lateral and bi-lateral assistance to improve his country's economy, to argue against budget disbursements. For example, the World Bank has told us that if the program goes off track, Development Policy
Credit (budget support) of USD 30 million would not be approved. The IMF may have to toughen its message in order to convince more lenient donors - such as Spain and the IADB - that Honduras is unwilling to take needed measures to help its economy stabilize in the long term. Garza, too, said the IADB should do its own thorough macroeconomic assessment. We share his concern that the IADB will attempt to bend the rules in order to continue providing budget support as the IMF program fails. End Comment.
HENSHAW